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Applying a Uniform Qualifying Tax Rate over the Entire State

Prepared for the Citizens Finance Review Commission

by

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The proposal is to apply a uniform tax rate equal to the Qualifying Tax Rate (QTR) over the entire state.

ADMINISTRATION OF PROPOSAL

In Arizona, the amount of primary property tax to be levied by a school district is determined primarily by a per student school expenditure limit formula. For the purpose of describing the application of a uniform tax rate equal to the QTR, expenditures outside the formula that are funded by the primary property tax such as desegregation expenses or excess utility expenses and expenditures funded by the secondary property tax are not relevant.

First, pursuant to the formula, the school district determines its financial need. This amount is divided by the property value in the district to determine the primary property tax rate. This rate is capped by the QTR, which is set by the state. Any need above what can be generated by the QTR is provided for by the District through statutorily prescribed sources of equalization assistance payments or state aid. A.R.S. §15-971.

Most school districts in Arizona apply the QTR and receive some amount of state aid. However, there is property that is not located in a school district, i.e., property in unorganized school districts. In these taxing districts, the state levies 50% of the QTR, and the money received pursuant to this tax goes to the state general fund and is to be used to pay state aid to other school districts. A.R.S. §15-991.01. Under the proposal, the state would levy 100% of the QTR in unorganized school districts.

In addition, certain school districts that have such high property valuation compared to the number of students in the district do not levy the full QTR and do not receive state aid. In some of these districts the tax rate is less than 50% the QTR. In those districts, the state levies 50% of the QTR less the amount of primary property tax that is levied by the school districts. A.R.S. §15-992. The money collected by the state goes to the state general fund and is to be used to pay state aid to other school districts. Under the proposal, the state would levy 100% of the QTR less the amount levied by the school districts for formula driven expenditures in all school districts that do not levy the full QTR.

IMPACT ON EXISTING REVENUE SYSTEMS

The proposal is an additional property tax assessed on certain properties. The additional tax would be levied by the state and go to the general fund. In a static model, this proposal would not impact any of the existing revenue systems. A discussion of the potential affects of the proposal in a dynamic model is below.

COST OF THE ADMINISTRATION OF THE PROPOSAL

Cost of Administration for the Tax Collector

The state already levies 50% of the QTR in unorganized school districts. In unorganized school districts, it would be easy for the state to increase the amount levied to 100% of the QTR.

Similarly, in high property value school districts, it also seems it would be easy for the state to levy 100% of the QTR less the amount of primary property tax levied by the school, as opposed to 50%. The incremental additional cost of administration should be minimal.

Cost of Administration for the Taxpayer

The property owners affected by the proposal already pay property taxes. This proposal simply increases the amount of property taxes certain property owners would be subject too. They would still receive one property tax assessment; just the amount would be different.

POLICY CONSIDERATIONS

Equity

In addressing *Equity* consideration should first be given to the fundamental purpose of the QTR, which appeared in Arizona in about 1980. It was to deal with the disparity in taxable wealth between school districts – resulting in inequalities of spending between students and high tax burdens in low-wealth districts. The Arizona Supreme Court said in *Roosevelt v. Bishop*: “The quality of education a child receives should not depend on whether the child lives in a wealthy or poor school district” and mandated a change that would result in increased horizontal equity between all taxpayers.

Horizontal equity does not exist under the present system for the following reasons:

1. Unorganized school districts and higher wealth districts that can fund their budget with a rate less than 50% of the QTR are only required to levy 50% of the QTR.
2. School districts may exceed budget limitations and construction standards through voter overrides, which are clearly more achievable in high wealth districts than low wealth districts.

The equity considerations for the proposal need to be done separately for each of the affected class of taxpayers. First, consider the impact on property in unorganized school districts. Under the current system, the tax assessed on property located in unorganized school districts at a rate of 50% of the QTR is generally less than the primary property tax levied by schools on property located in school districts. By requiring property owners in each district to pay primary property tax at a comparable level, the proposal increases the horizontal equity within the property tax system. Requiring property owners that have property in high wealth districts have a comparable primary property tax rate for schools as property owners that have property in low wealth districts increases the horizontal equity within the property tax system. In Arizona, the property tax districts that have the highest property values are those districts that contain a mine or an electric generation facility. As a result, a relatively low rate of tax results in a large tax

assessment on these large property investments. In order to determine the effect on equity on mines and utilities, a more complete study of the entire tax burden on these industries and others is required.

Mines and electric utilities have high investments in capital construction. Other industries do not make the amount of investment in capital when compared to revenues or profit. Thus, taxing all business property at a uniform rate results in capital-intensive industries paying more tax than industries that have a low investment in property. But without consideration of the overall tax burdens on each industry sector, equity cannot be determined.

On the other hand, the specific effect on mines and utilities must be understood in the context of the purpose of a property tax. A tax on property is a tax on capital or wealth. A dollar's worth of value in any type of property represents the same wealth as a dollar's worth of any other type of property. An industry making a high investment in capital construction is not different than a homeowner making a high investment in a home. The result is greater property wealth. A tax at the same rate results in a higher tax on both types of property. Furthermore, investors are willing to provide additional capital investment for the potential of higher returns on their investment. Regulated utility companies are guaranteed the opportunity to earn a fair return on their investments – an opportunity that is not guaranteed to any other industry. Therefore, the tax system should not attempt to compensate for risks that investors are willing to make and the fact that more capital intensive industries may pay higher property taxes should be irrelevant to tax policy.

Economic Vitality

To the extent that certain retirement communities see an increase in property tax due to the increase in unorganized school districts, these communities may see some slow down in growth. However, as residential property tax would still be relatively low in these areas compared with the rest of the country, the negative effect should be negligible. Standardizing rates may have a beneficial effect on the economy by eliminating the low (value-added) efforts devoted to garnering these specific benefits. That is, resources are less likely to be squandered in the pursuit of an arbitrary tax benefit if it doesn't exist.

As far as high wealth districts are concerned, Arizona has high business property taxes that are not competitive with states Arizona competes with for growing and expanding businesses. Arizona's overall tax burden on business is slightly higher than the national average. To the extent the proposal is an additional property tax assessed in the manner that continues to exacerbate an already problematic area, the proposal detracts from the competitiveness of the property tax system for the utilities and mines. But, the property tax burden cannot be the single factor of comparison for the purpose of evaluating competitiveness. For instance, Arizona does not rely heavily on its severance tax while some competitor states are heavily reliant on such a tax. Texas relies heavily on a heavy franchise tax and less on business property and corporate income tax.

While Arizona may have relatively high property taxes for business, Arizona is highly rated in all business climate surveys. The Cognetics Top 10 for small business lists Arizona second

behind only Nevada. Phoenix is rated #1 out of 50 large metro areas for small business. Overall, the Tax Foundation puts Arizona at 17th in its Business Tax Climate Index for 2002. Clearly, numerous factors have to be considered when assessing the impact of the proposal on economic vitality.

The increase of property tax on businesses associated with this proposal could exacerbate a problem that already exists, that is, Arizona's property tax burden on businesses is not competitive with surrounding states and other regions Arizona competes with and is a detriment to Arizona's economic vitality. The study of business tax burdens being done by the Chamber of Commerce may supply some of the more detail comparative data needed to evaluate this standard.

Additionally, if a property tax increase to electric utilities was dramatic enough, it could effect the industry profits or rates. The impact on stock prices or rates might have a measurable impact on economic vitality. For instance, consumers of electricity, particularly businesses that use a great deal of electricity such as high tech industries might be less inclined to move or to expand in Arizona. Electricity costs are one of many factors that determine the cost of operations in one state versus another and the impact on business location and expansion competitiveness would need to be measured in relation to the overall business development factors. Similarly, to the extent Arizona's mines see a dramatic impact in property tax, their viability could also be negatively impacted.

Others would argue that this is pure speculation and that anything with a "dramatic enough" impact could affect earnings and stock prices. Electric prices in Arizona have actually declined in real terms over the last 10 years. APS is currently seeking a 10% rate increase from the Arizona Corporation Commission. Any additional burden that the proposal represents would be minor in comparison.

Of course, the mining and electric utility industries are less mobile than other industries. Some would argue that these sectors of the economy are less likely to be impacted by a property tax increase than more mobile manufacturing industries that also have high investments in capital.

Therefore, it is difficult to measure the exact impact of this proposal on economic vitality. Like most business tax issues, the overall effect on economic viability must consider other factors that generate the quality of the economic development climate.

Finally, mines (copper mines in particular), power plants, large manufacturers, and retirement all bring money from outside the state and add to economic growth. New investment from these parties is more discretionary and therefore tax-elastic than some other types of economic investment. This may impact future investment and growth of these industries in the state. While retirees might consider alternate locations, their tax burden is so low already that their tax elasticity will be pretty low.

Volatility

Property taxes are generally considered the most stable source of revenues.

Simplicity

The proposal would require a few small changes to existing statutes to be implemented.

The impacted property owners would see an increase in their property tax assessments.

If the electric utility industry chooses to increase rates to compensate for the property tax increase, the proposal will be less “transparent.” The tax increase could be hidden in increased electric utility rates.

ECONOMIC IMPACT

For property tax year 2002, there was \$728 million in Primary Net Assessed Value in the ‘unorganized school districts’ mentioned in the example. The largest known unorganized school districts are Sun City and Green Valley. The rate paid by these property owners for the 2002 property tax year was \$2.0296, bringing in roughly \$15.3 million to support Basic State Aid. If property owners in these districts were asked to pay the full QTR, which would have been \$4.0592 in tax year 2002, an additional \$15.3 million would have been raised. This would affect all property owners in these areas.

According to an estimate determined by the Department of Revenue, the revenue generated by assessing the full QTR in high property wealth school districts in 2003 property tax year would have been about \$20 million. An additional \$8-12 million may also be generated from school districts that are not considered high wealth districts, but do not require state aid due to rapid property wealth growth as compared to school spending needs. The second figure is less predictable from year-to-year.